

REPORT
PREPARED FOR
London Borough of Bromley
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Investing in high dividend yielding stocks

At the meeting of the Pensions Investment sub Committee ("PISC") held on 19 May 2015, members agreed to switch £6m, in two tranches of £3m each, from the Baillie Gifford Sterling Aggregate Plus Fund into the Baillie Gifford Global Bond Fund and the Baillie Gifford Emerging Market Bond Fund.

A second proposal to switch a similar amount from the Fidelity UK Aggregate Bond Fund to the Fidelity FIDA Fund was not agreed. Following further discussion, the Committee agreed to switch £6m from the Fidelity Fund to a fund wherein high yielding equities might generate a better return than that expected from retaining this £6m in fixed income. This investment might then be moved back to fixed income assets should market rates of return "normalise".

The Independent Investment Adviser was asked to provide the name of a suitable manager from those currently providing global equity investment management services to L B Bromley Pension Fund, to whom these funds could be directed.

These managers are:

Baillie Gifford

BlackRock

MFS

At the recent meeting of the PISC, members noted the strong investment performance of all three managers since inception.

Whilst the Baillie Gifford Global Alpha Fund is closed to new clients, it remains open for new money from existing clients; both BlackRock and MFS remain open to new clients and new money.

In noting the members' request, Mr Stevenson confirmed that the current strategic asset allocations of the Fund were:

	Long term strategic as at 31 March 2015	Actual asset allocations as at 31 March 2015	Forecasted allocations post £6m transfer to Equities
Equities	70.0%	(74.0%)	(74.8%)
Fixed Income	20.0%	(15.9%)	(15.1%)
Diversified growth Funds	10.0%	(10.1%)	(10.1%)

Asset allocations, should the additional £6m transfer from fixed income to equities be made, are shown in the third column and indicate an ***underweight of approximately 5.0% to the strategic fixed income allocation, which is effectively funding a contrasting 5.0% overweight position in equities***

The top ten dividend yields in the MSCI AC World Index as at 31 March 2015 are shown in the table on the following page.

Stock	Country	Sector	Index Weight	Div Yield 2015
Centrais Elet Bras	Brazil	Utilities	0	17.5
American Capital Agency Corp.	US	Financials	0.02	12.1
Annaly Capital Management, Inc.	US	Financials	0.03	11.1
Direct Line Insurance Group Plc	UK	Financials	0.02	10.9
PT Indo Tambangraya Megah Tbk	Indonesia	Energy	0	10.9
Transmissora Alian	Brazil	Utilities	0	10.7
MMC Norilsk Nickel JSC	Russia	Materials	0.03	10.4
AES Tiete SA Pfd	Brazil	Utilities	0	10.3
Tabcorp Holdings Limited	Australia	Consumer Discretionary	0.01	9.9
Crescent Point Energy Corp.	Canada	Energy	0.02	9.8

High Yielding stocks tend to be either those where the historic yield is unsustainable (i.e the dividend is about to be cut) or those stocks operating in industries with strategic challenges and low growth opportunities giving the company limited scope to invest. This means that high yield stocks tend to be concentrated in certain industries and will show, on average, limited growth over the long term. The higher the yield targeted the greater the concentration in declining industries and thereby idiosyncratic risk. Currently high yield stocks are concentrated in oil and mineral extraction companies, utilities, retailers and financials.

Please note Annex A for additional comment.

Whilst I recognise that members wish to see additional income generation, I do not believe that investing in this manner is conducive to sound pension fund management or governance as the recommendation to make this “switch”, is essentially based on attempting to time both market entry and exit in order to generate potential additional income.

The London Borough of Bromley Pension Fund exists to provide and fulfil the “promise of payment” of agreed pension benefits to its members over the long term, not to try and time the market for a short term gain.

Recommendation

- **No further action be taken and the funds earmarked for this “switch” be retained within the current fixed interest portfolio managed by Fidelity.**
- **Should the members decide to proceed, against the above advice, then I would recommend funds be placed with BlackRock in their Global Equity Enhanced Index Fund which is a pooled fund with daily dealing, rather than Baillie Gifford and MFS which manage segregated portfolios, purely on the grounds of speed and efficiency in processing the small transition.**

ANNEX A

In November 2013, Threadneedle Investment Management presented their Global Equity Income driven product offering to the PISC as part of the final series of presentations for the new Global Equity mandates (Phase 2).

At that time members observed that a 4% dividend target return might be difficult to achieve, given the then current global economic conditions, in addition they felt that the product was very much controlled by one investment professional who had developed, managed and “owned” the performance of the product being offered.

Recent conversations with Threadneedle (27th May 2015) have confirmed the accuracy of those comments, especially on dividend sustainability.

The five key criteria for including stocks in the portfolio were:

Dividend yield	> 4.0%
Earnings growth	> 5.0%
Dividend growth	> 5.0%
Gearing	< 75%
Dividend cover	> 1.25x

If the dividend yield on a stock, within the portfolio, were to fall below the 4% threshold, and if the manager could not see the dividend moving back across the 4% threshold within 12 months, then the stock would be sold.

The manager is currently evaluating, and will likely implement, a move to drop the target dividend yield to >3.0%, by stock given the decline in the number of stocks yielding >4.0%.

Whilst this would be unlikely to dramatically change the current stock list, it would remove the requirement to sell stocks that fall below the 4.0% criteria listed above, but which remain above the 3% floor.

Members might also be interested to know that of the ten top dividend returning stocks in the MSCI ACWI index as listed on page 3, the manager only holds Crescent Point Energy Corp, the lowest ranking of the top ten.